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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Allocation of Costs Associated with	)	CC Dkt. No. 96-112
Local Exchange Carrier Provision of Video	)	
Programming Services	)	

REPLY COMMENTS OF THE SOUTHERN NEW ENGLAND TELEPHONE COMPANY

DOCKET FILE COPY ORIGINAL

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SUMMARY

In its Reply, SNET reiterates its proposal that the FCC eliminate cost allocation regulation of any LEC whose telephony prices are subject to price cap controls. While a few cable operators assert in their Comments that even a price-cap-regulated LEC has a substantial incentive to misallocate costs in the absence of cost allocation regulation, their arguments are misplaced as SNET explains in its Reply.

Moreover, SNET urges the Commission to eliminate cost allocation regulation of any LEC whose exchange market is subject to competition. Sections 251 and 252 of the Communications Act define the circumstances in which a LEC's exchange market is deemed to be subject to competition. Those provisions (i) require a LEC to negotiate agreements which permit competitors to provide exchange service in competition with the LEC and (ii) provide a mechanism by which such agreements can be validated by regulators. Once a LEC obtains validation of an agreement, the Commission should automatically discontinue regulating the manner in which the subject LEC allocates costs.

If the FCC concludes that continued monitoring of SNET's cost allocations is necessary in order to protect telephony ratepayers from potential cross subsidization, it should hold that SNET's proposed allocation methodology provides the required protection. Under that methodology, SNET would continue to account for all network costs in its regulated asset and expense accounts, and it would recover a reasonable portion of its broadband network costs

from its cable TV affiliate, Personal Vision, pursuant to the agency's affiliate transaction rule (Section 32.27). SNET would recover these costs by providing Personal Vision with broadband transport service, and it would enter the charge for that transport service into its regulated revenue accounts. The amount of this revenue entry would be derived by requiring the transport service to bear (i) all direct and attributable costs associated with that service, and (ii) 50 percent of all common costs of SNET's new broadband loop plant.

Although the incumbent cable TV industry claims that nonregulated services must pay 70 percent or more of the common costs of new broadband loop plant in order to ensure that telephony subscribers obtain the benefits that new broadband networks make possible, the cable industry is wrong for reasons explained in SNET's Reply. In fact, requiring Personal Vision to pay more than 50 percent of the common costs of SNET's new broadband loop plant could deny benefits to both SNET's telephony ratepayers and to Personal Vision's cable subscribers as SNET also explains in its Reply.

Finally, SNET explains in its Reply why the Commission should not require LECs to make exogenous cost adjustments to their price cap indices under Section 61.45(d)(1)(v) as some commenters propose. SNET explains that Section 61.45(d)(1)(v) does not contemplate exogenous cost adjustments in this situation. It also explains why mandating exogenous cost adjustments is unnecessary to accomplish the objective that the proponents of such cost adjustments want to achieve.

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In this Reply, we explain why the initial comments of other parties validate the proposals SNET made in its own initial comments. In doing so, we organize the Reply into three parts.

Part I discusses why the FCC should eliminate cost allocation regulation for any LEC whose telephony prices are controlled by price cap regulation or for any LEC whose exchange market is open to competition.

Part II explains why the initial comments confirm that it would be a mistake for the FCC to require LECs to use the identical accounting methodology and the identical fixed factor for allocating common costs of new broadband loop plant. Part II also explains why the initial comments support a ruling by the Commission that use of the particular allocation approach which SNET has proposed is in the public interest for any LEC desiring to use it.

Part III explains why the Commission should reject the proposal by a few commenters that the agency require LECs to adjust their price cap indices to reflect the cost allocations they make as a result of this proceeding.

DISCUSSION

I. Initial Comments Confirm that the Commission Should Not Prescribe the Cost Allocations for Any LEC Whose Telephony Prices Are Controlled by Price Cap Regulation or Whose Telephony Market Is Open to Competition

The Commission should hold in this proceeding that it will automatically discontinue regulating the manner in which a LEC allocates costs if the LEC meets either of two conditions. Each is discussed below.

First, a LEC's cost allocations should not be regulated if the LEC's telephony rates are controlled by price caps. By decoupling telephony rates from telephony's allocated costs, price cap regulation substantially eliminates the theoretical justification for regulating the manner in which a LEC allocates costs.[1/] The Commission itself has found this to be so.[2/] So has the U.S. Court

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[1/] SNET Comments at 4-5; Bell Atlantic Comments at 1-3; BellSouth Comments at 4-5; NYNEX Comments at 4-6; GTE Comments at 5-6; Ameritech Comments at 4-8; Pacific Bell and Nevada Bell Comments at 3-6; USTA Comments at 4-6; Southwestern Bell Comments at 24-25. Not only are SNET's interstate access telephony rates controlled by a form of price cap regulation, so too are its exchange rates and its in-state access rates.

[2/] SNET Comments at 5 (noting that the Commission has held that price-cap regulation "substantially decrease[s] incentives to shift costs from more to less competitive service offerings" and "reduce[s], if not eliminate[s], any perverse incentive to inflate [the] rate base.")

of Appeals.[3] So have numerous economists,[4] including the FCC's own chief economist.[5]

Second, the Commission should automatically discontinue regulating the manner in which a LEC allocates costs if that LEC's exchange telephony market is open to competition.[6] Regulating cost allocations of a LEC whose exchange market is open to competition serves no useful purpose since a LEC which is subject to competition has no economic incentive to overallocate costs to telephony. Sections 251 and 252 of the Communications Act define the circumstances in which a LEC's exchange market is deemed open to competition. Those provisions require a LEC to negotiate agreements which permit competitors to provide exchange service in competition with the LEC and provide a mechanism (in Section 252(e)) by which such agreements can be validated by regulators.

3/ Id. (quoting the Court as stating that "price cap regulation...reduces [the LEC's] ability to shift costs...because the increase in costs for the regulated [service]...does not automatically cause an increase in the legal rate ceiling [for regulated service]").

4/ Bell Atlantic Comments at 2-3. See also Affid. of Dr. William Taylor at 5, attached to SNET Comments.

5/ Bell Atlantic Comments at 3. Cable commenters are wrong when they argue that Section 220(a)(2) of the Communications Act requires the Commission to regulate the manner in which a price-cap-regulated LEC allocates costs even if no valid purpose is served by doing so. Cox Comments at 12 n.15; Comcast and Adelphia Comments at 9. In fact, Section 10 of the Act, 47 U.S.C. ¶160, prohibits the Commission from enforcing any regulation otherwise required by the Act (with specific exceptions not applicable here) when enforcing the regulation serves no valid purpose. For reasons described above, no valid purpose is served by regulating the manner in which a price-cap-regulated LEC allocates its costs.

6/ SNET Comments at 6-9; BellSouth Comments at 2, 3, 7-8; Pacific Bell and Nevada Bell Comments at 5.

While a number of LECs have negotiated such agreements, none has been validated yet as complying with Sections 251 and 252. But once validation occurs, the Commission should automatically discontinue regulating the manner in which the subject LEC allocates costs.

II. The Commission Should Not Require LECs to Use a Single Allocation Approach, but It Should Allow All LECs Desiring to Do So to Use the Approach SNET Has Proposed

For LECs whose cost allocations are regulated, the Commission should not require that all of them protect telephony subscribers from possible cross-subsidization by using the same accounting methodology and the same fixed factor to allocate the common costs of new broadband loop plant. While the agency's tentative proposal in the Notice to require all LECs to use the same allocation approach is understandable, the comments make clear that it would be unwise to impose this requirement. For example, mandating each and every LEC to use the same fixed factor to allocate broadband loop common costs plainly could result in allocations to telephony and broadband service which are unreasonable for some LECs.[7/] Requiring all LECs to use the same cost pools also would be needlessly constraining.[8/] Requiring all LECs to protect telephony ratepayers from cross-subsidization by allocating costs rather than by attributing revenue to regulated accounts in accordance with the

[7/] SNET Comments at 9-10; Puerto Rico Tel. Co. Comments at 3; Pacific Bell and Nevada Bell Comments at 7-8; US West Comments at 6-7; BellSouth Comments at 20-22; GTE Comments at 4-5; USTA Comments at 6-12; Bell Atlantic Comments at 9.

[8/] USTA Comments at 17; US West Comments at 6.

FCC's affiliate transaction rule likewise would be needlessly inflexible.[9]

While the Commission should not require all LECs to use the same accounting methodology or the same fixed factor to allocate new broadband network common loop costs, the agency should hold in this proceeding that the approach SNET has proposed to protect against cross subsidization is acceptable. It also should hold that SNET (and any other LEC) may use that approach at its discretion. That approach has two key elements as SNET explained in its Comments.[10]

- Since <u>all</u> non-regulated activities are provided by affiliates of SNET's parent other than SNET, SNET is not required under existing FCC rules to divide assets and expenses into discrete cost pools and then allocate these pools between regulated and non-regulated activities. SNET will account for its network costs in its regulated asset and expense accounts, and it will recover a reasonable portion of those costs from its cable TV affiliate, Personal Vision, by providing Personal Vision with broadband transport service. SNET will enter into its regulated revenue accounts its charge for that transport service. Using this accounting methodology is consistent with the FCC's affiliate transaction rule (Section 32.27).

- The charge for providing broadband transport service to Personal Vision which is included in SNET's regulated revenue accounts will be the amount that reimburses SNET for (i) all direct and attributable costs associated with that service and (ii) 50 percent of all common costs of SNET's new broadband loop plant. This simple approach has the effect of reducing SNET's telephony costs by the amount

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[9] SNET Comments at iii, 11-12.

[10] <u>Id</u>. at 11-12, 15-22.

of revenue recorded, and it eliminates the need for SNET to employ cost pools.[11/]

The incumbent cable TV industry argues that unless nonregulated services pay 70 percent or more of the common costs of new broadband loop plant, telephony subscribers will be denied the very benefits which even that industry admits such networks make possible.[12/] But the cable industry is wrong. As a matter of economics, the benefits of a LEC's broadband network will be enjoyed by those who subscribe to telephony as long as telephony bears all of its incremental costs and less than all common

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[11/] While SNET will recover all new broadband loop costs in the manner described above, it will recover broadband interoffice transmission costs by offering interoffice transmission to all interested parties, including Personal Vision, pursuant to Federal tariff, and it will record all revenues obtained under this tariff on its regulated revenue accounts just as is the case for all other Federal tariffs. Id. at 21-22. Although Personal Vision's cable service will be the first broadband service to utilize SNET's new broadband network, other broadband services may be added in the future. SNET explains in its Comments that as each new broadband application is added, SNET will allocate some common broadband loop plant costs to the new service by reducing the initial allocation of all new broadband loop common costs to the telephony and cable transport categories. Id.

[12/] While some cable operators ask the Commission to mandate that LECs allocate 70 percent of all broadband loop common costs to nonregulated services (Comcast and Adelphia Comments at 7), others request that an even larger percentage of these costs be allocated to nonregulated service. See Time Warner Comments at 10-11 (proposing a 75/25 allocator); Cox Comments at 7 (proposing a 75/25 allocator); NCTA Comments at 20 (proposing a 75/25 allocator), California Cable TV Ass'n at 19-20 (proposing a 76/24 allocator); and Continental Comments at 7, 10 (implying that a 95/5 allocator is appropriate). NCTA goes so far as to claim that "it's easy to postulate circumstances under which even a 100 percent allocation of common costs to video would be insufficient to prevent cross-subsidization." NCTA Comments at 24.

costs.[13] SNET's telephony subscribers obviously will benefit from the new SNET broadband network since they will bear all incremental costs of telephony and less than all (indeed, just 50 percent) of SNET's new broadband loop common costs.[14]

While requiring Personal Vision to pay 50 percent of SNET's new broadband common loop plant costs plainly will allow SNET's telephony subscribers to share in the benefits of that network, requiring Personal Vision to pay more than 50 percent of these costs could deny these benefits to both SNET's telephony ratepayers and to Personal Vision's cable subscribers by making the new network uneconomic. This could happen because setting the price of

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[13] See Affid. of Dr. William Taylor attached to SNET Comments.

[14] Some cable operators speculate that telephony subscribers might not benefit even when relieved from the obligation to pay 50 percent of the common costs of new network loop plant on the theory that more than 50 percent of these common costs may be incurred in order to provide video and other non-telephony services rather than to provide telephony. See, e.g., Affid. of Leland Johnson, attached to NCTA Comments. But these cable operators offer no basis upon which the Commission could conclude that LECs will over-engineer their broadband telephony networks in order to provide non-telephony services. Not only does this "overengineering" theory lack record support, it is absurd on its face. LECs have no economic incentive to build new goldplated telephony networks given the exchange service competition that is looming. In addition, the Connecticut DPUC and FCC price cap regulatory regimes provide incentives for SNET to deploy a more efficient and productive network, not a gold-plated network. In fact, SNET has shown that its telephony subscribers should benefit substantially from the scope economies which its new broadband network will allow. As broadband loop plant is deployed, SNET will retire existing narrow-band loop infrastructure thereby reducing telephony costs. For example, expenses to operate SNET's broadband network should be $74 less per access line than expenses to operate the existing network due to the increased reliability of fiber technology and the self-healing features that will be built into SNET's new network. See Transcript in Dkt. No. 95-03-01 at 1053-54 (Dept. of Pub. Util. Control, Sept. 27, 1995).

transport service at a rate which requires Personal Vision to bear more than 50 percent of these common costs could require Personal Vision to price its cable service above the price of comparable service offered by incumbent cable TV operators.[15/]

The cable industry's request for a rule requiring that LECs allocate more than 50 percent of their new broadband common loop plant costs to nonregulated services also is inconsistent with some of the cable industry's earlier proposals. Comcast admits in its comments that it earlier had advocated a 50/50 allocator for new broadband loop common costs but claims that it decided to up the ante when it concluded that Congress would support it doing so.[16/] But Comcast does not explain why Congressional support for a 70/30 allocator (even if true) has any bearing on its own earlier expressed view that a 50/50 allocator would produce a reasonable allocation of common costs to telephony.

Cox has an equally troublesome explanation for upping the ante. While admitting that it too once advocated a 50/50 allocator, Cox now falsely claims that it proposed that allocator only

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[15/] Since a decision about what percentage of the common costs of new broadband loop plant is arbitrary, the selected percentage allocator is reasonable only if it does not harm the market prospects of a service. See Taylor Affid. at 10-11 attached to SNET Comments. In addition, it makes no sense to require that SNET allocate a majority of broadband loop plant common costs to broadband service when nearly 90 percent of the direct costs of the company's new broadband network will be attributable to telephony. The cable industry's motive for asking the Commission to force Personal Vision to absorb such high allocations of common costs is obvious: the cable industry benefits financially to the extent Personal Vision's prices are kept high.

[16/] Comcast/Adelphia Comments at 7, n.10.

if applied to all costs of deploying and operating a new broadband network, rather than new common costs alone.[17] In fact, Cox informed the Commission last July that it would accept an allocation of 50 percent of the common costs of SNET's broadband network.[18]

Adelphia and Jones Intercable also are on record as stating that "a 50/50 split of broadband network common costs between video and telephony . . . is the absolute minimum necessary" to ensure that LEC-provided multi-channel video services bear a reasonable share of costs.[19]

Significantly, every state regulatory commission which filed comments agrees that a 50/50 allocator for new broadband loop common costs would not under-allocate these costs to telephony.[20] The views of state regulators are important since state regulators have at least as great an interest as the Commission in ensuring that a LEC's telephony rates do not subsidize other services pro-

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[17] Cox Comments at 5 n.7.

[18] Reply of Comcast and Cox to SNET's Opp. to Petitions to Deny at 5-6 (W.P.C. 7074, July 21, 1995).

[19] See Letter from counsel for Adelphia, Comcast, Cox and Jones Intercable at 2, Bell Atlantic Tariff F.C.C. No. 10, Transmittal No. 741 (May 15, 1995).

[20] New York Dept. of Pub. Service Comments at 3; Alabama Pub. Service Com'n Comments at 6; Florida Pub. Service Com'n Comments at 2-3; California Pub. Util. Com'n Comments at 4.

vided by that LEC, and they are likely to have a more informed perspective on LEC costs than any other non-LEC commenter.[21]

III. Those Who Want the FCC to Order Mandatory Adjustment of LEC Price Cap Indices to Account for Broadband Network Cost Allocations Made as a Result of this Proceeding Fail to Show that this Action Would Be Either Lawful or In the Public Interest

The Commission should not require exogenous cost adjustments to LEC price cap indices under Section 61.45(d)(1)(v) to ensure that telephony ratepayers share in broadband network economies of scope as some commenters propose. First, Section 61.45(d)(1)(v) will not apply to SNET if SNET accounts for its broadband revenues and costs under the agency's affiliate transaction rule as it has proposed. Section 61.45 requires adjustments in price cap indices only when the costs allocated to telephony change due to regulatory changes. The costs SNET allocates to telephony will not change due to new regulatory policies since all costs of SNET's new broadband network will be allocated to telephony, just as all costs of SNET's existing network are allocated to telephony. Instead of changing costs, Personal Vision's use of SNET's broadband network to provide cable TV service will increase the revenues recorded on SNET's regulated accounts since SNET will provide Personal Vision with transport service as an affiliate transaction under Section 32.27.

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[21] The long distance industry also appears to believe that forcing LECs to allocate more than 50 percent of common costs to nonregulated services could be unreasonable. See AT&T Comments at 7 (supporting a LEC's use of a 50/50 common cost allocator, at least for a temporary time); GCI Comments at 4 (stating that a LEC's use of a 50/50 allocator appears to be "a reasonable . . . factor to accomplish the [FCC's] stated purposes").

As explained above, SNET will not be providing nonregulated video service.

Nor is AT&T correct in contending that Section 61.45(d)(1)(v) will apply to those LECs who do allocate broadband costs to nonregulated service in accordance with whatever requirements the FCC adopts in this proceeding.[22] Section 61.45(d)(1)(v) applies only if costs are reallocated -- from regulated service to nonregulated service -- as a result of regulatory action.[23] No such reallocation will occur as a result of FCC action in this docket since LECs are only now beginning to deploy broadband loop plant.

The claim that failure to adjust a LEC's price cap indices to reflect the allocation of broadband costs to nonregulated services requires the LEC's telephony subscribers to subsidize its nonregulated service subscribers also is false.[24] A LEC's telephony service does not subsidize its nonregulated service as long as the nonregulated service recovers its incremental costs.[25] FCC rules already require that a LEC assign to nonregulated service all incremental costs of that service. Moreover, the economies of scope that a LEC's new broadband network make possible will be reflected in the LEC's telephony rates through the productivity

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[22] AT&T Comments at 10-11.

[23] Bell Atlantic Comments at 6-7; BellSouth Comments at 11-13.

[24] Cox Comments at 10-11; Comcast and Adelphia Comments at 8-9.

[25] See, e.g., Affid. of Dr. William Taylor attached to SNET Comments.

factor offset to LEC price cap indices which is built into the price cap rules.[26/]

CONCLUSION

The Commission should take action in this proceeding consistent with SNET's recommendations.

Respectfully submitted,

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[26/] Id. at 5-6. See also BellSouth Comments at 14; Pacific Bell and Nevada Bell Comments at 17-18; Bell Atlantic Comments at 5.

Certificate of Service

I certify that, on June 12, 1996, I mailed a copy of the foregoing "Reply Comments of The Southern New England Telephone Company" to the following:

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